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In the Supreme Court of the United States

OCTOBER TERM, 1982

PIGGY BANK STATIONS, INC.,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTIONS PRESENTED

I. The corporate taxpayer advanced funds to a computer corporation (hereinafter Computer) in which the taxpayer was a minority stockholder. Computer provided services to taxpayer until it became insolvent. In determining whether the advances were bad debts deductible for income tax purposes the Fifth Circuit held the advances were contributions to capital rather than bona fide loans. The question presented is:

> Did the Fifth Circuit err in holding that since repayment of the advances was contingent on future profits, equity capital rather than loans existed, which reasoning is in direct conflict with the decisions in the Sixth and Ninth Circuits and in accord with the Fourth and Eighth Circuits?

II. In addition to the taxpayer's advances to the computer corporation, that corporation subsequently obtained refinancing from a third party. The Fifth Circuit held that third party loan were not "readily available". The question presented is:

> Did the Fifth Circuit err in holding advances were capital in nature rather than loans when the taxpayer proved a substantial third party loan was in fact made but did not prove other loans were "readily available", a concept more stringent than that applied in the Second, Third, and Eighth Circuits?

III. The corporate taxpayer made advances to a partnership which expended some funds benefiting the corporation and the balance for the partnership's own purposes.

The Fifth Circuit held the use of the advances by the partnership could not be allocated, therefore no bad debt was incurred. The question presented is:

> Did the Fifth Circuit err in holding that a tracing of the use of corporate advances by the recipient is a necessary element for a bad debt when the Internal Revenue Code in Section 166(d) applies that test only to loans by individuals, not corporations? Was the Court's holding a faulty statutory construction that will affect every corporate lender?

TABLE OF CONTENTS

PAGE

QUESTIONS PRESENTED i
TABLE OF CONTENTS iii
TABLE OF AUTHORITIES iv
CITATIONS TO OPINION BELOW 1
JURISDICTION 2
STATUTES 2
STATEMENT OF THE CASE 2
REASONS WHY THE WRIT SHOULD BE GRANTED 4
CONCLUSION AND PRAYER 9
PROOF OF SERVICE 10
APPENDIX A-1

TABLE OF AUTHORITIES

PAGE

Austin Village, Inc. v. United States,
432 F.2d 741 (6th Cir. 1970) 7

Byerlite Corp. v. Williams,
286 F.2d 285, 291 (6th Cir. 1960) 5

Earl v. W. J. Jones & Sons, Inc.,
200 F.2d 846, 851 (9th Cir. 1952) 6

Fin Hay Realty Co. v. United States,
398 F.2d 694 (3rd Cir. 1968) 7

H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 76-78
CB 1942-2, p. 431; S. Rep. No. 1631, 77th Cong.
2d Sess., pp. 90-91, CB 1942-2, p. 573 8

Helvering v. Richmond F. & P.R. Co.,
90 F.2d 971, 974 (4th Cir. 1937) 5

In Re Indian Lake Estates,
448 F.2d 574 (5th Cir. 1971) 7

In Re Uneco, Inc.,
532 F.2d 1204 (8th Cir. 1976) 7

Nassau Lens Co. v. Commissioner,
308 F.2d 39 (2nd Cir. 1962) 7

Tomlinson v. 1661 Corp.,
377 F.2d 291 (5th Cir. 1967) 7

Rowling-Moxley Co. v. United States,
586 F.2d 723 (8th Cir. 1978) 5

IN THE
SUPREME COURT OF THE UNITED STATES
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PIGGY BANK STATIONS, INC.,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The petitioner, Piggy Bank Stations, Inc. respectfully prays a Writ of Certiorari issue to review the Judgment and Opinion of the Fifth Circuit Court of Appeals entered on this proceeding on March 21, 1985 and the denial of a Petition for Rehearing and a Suggestion for an En Banc hearing on April 25, 1985.

CITATIONS TO OPINIONS BELOW

The United States Tax Court, Judge Whitaker, entered its Decision in Tax Court Memo Dec. (P-H) paragraph, 82,365. On rehearing, the United States Tax Court, Judge Whitaker, entered its Decision in Tax Court Memo Dec. (P-H) paragraph 83,668. The Fifth Circuit Court of Appeals, Judge Gee, entered its Decision in

_____F.2d_____, (Fifth Circuit 1985).

JURISDICTION

Petitioner appeals from the judgment of the Fifth Circuit Court of Appeals decided March 21, 1985. Petitioner's petition for rehearing en banc was denied on April 25, 1985. Jurisdiction of this Court is invoked under 28 U.S.C. 1254 and 2101, and Supreme Court Rule 19.

STATUTES

Internal Revenue Code Section 166 (Appendix)

STATEMENT OF THE CASE

Piggy Bank Stations, Inc. and Piggy Bank, Inc. and Subsidiaries are Texas corporations with principal places of business in El Paso, Texas. Their coporate income tax returns were filed with the office of the Internal Revenue at Austin, Texas.

Piggy Bank Stations (hereinafter Stations) and Piggy Bank Land (hereinafter Land) were, until March 31, 1976, affiliated corporations, each being owned in equal shares by Sam S. Klink and William Johnstone. Stations was in the business of owning, leasing and operating gasoline stations. Land was in the business of owning the property. In March, 1976, Stations and Land were sold to a newly formed corporation, Piggy Bank, Inc.

General Computer Services, Inc. (hereinafter Computer) was formed prior to 1972 to capitalize on computer programs developed to facilitate internal reporting and ac-

counting control of Station's business. Johnstone owned 3% of the stock of Computer and Klink owned 16.31%. From its inception Computer was undercapitalized and Stations and other customers paid in advance for services rendered in order to receive the services. From some time before December 31, 1972 through December, 1974, the operating expenses of Computer were paid in whole or in part with funds derived from Stations. During the period Computer incurred substantial amounts of secured and unsecured indebtedness including a Small Business Administration loan totaling more than $300,000.00 and a $300,000.00 loan from Greyhound Corporation. On January 3, 1975, Computer executed a contract with Greyhound Computer Operation to take over its entire operation. Pursuant to this contract, Greyhound extended its existing loan of $300,000.00 to Computer and loaned the company an additional $1,150,000.00. None of the indebtedness owed to Stations and Land was converted into stock when Greyhound took over Computer.

Stations claimed a bad debt deduction in the amount of $321,105.00 with respect to advances to Computer for the year ended November 30, 1975, due to Computer's insolvency. The Fifth Circuit disallowed the deduction on the grounds that repayment of the advances was contingent on future profits of Computer and that after 1973 or 1974 Computer was not "readily able" to obtain third party financing and therefore Station's advances constituted capital contributions rather than bona fide debts.

Klink was also one of two equal partners in the Browne and Klink partnership (hereinafter B&K) which was engaged in various land development projects. Stations and Land advanced funds to the partnership for use

in its land development business. By March 31, 1976, B&K owed $8,500.00 to Land and $244,870.00 to Stations. Due to the insolvency of B&K these amounts were written off by Stations and Land as bad debts as of March 31, 1976. The Fifth Circuit disallowed the deduction on the ground that Stations and Land had not traced the amount of advances used by B&K to develop service stations and that amount used by B&K for its own partnership purposes, thus regarding the use of corporate advances by the recipient as a necessary element for a bona fide loan eligible for a bad debt deduction.

REASONS WHY THE WRIT SHOULD BE GRANTED

The deduction of bad debts by corporate lenders is common in the business world. Whether a corporation is entitled to a bad debt deduction for income tax purposes presently depends solely upon which court has jurisdiction over its case. There is no uniformity, rather conflict, between circuits in applying the various tests for deductibility. The instant case could well serve as a vehicle for the Court to express the proper standards for the facts here present raise the issues on which the several circuits have differed.

I.

In the instant case, the Fifth Circuit disallowed Station's and Land's bad debt deduction on the ground that since repayment of the advances to Computer was contingent on the future profitability of Computer the advances were in the nature of capital contributions rather than bona fide loans eligible for a bad debt deduction. The test applied by the Fifth Circuit to differentiate between

debt and equity capital is in accord with that used by the Fourth and Eighth Circuits but in direct conflict with decisions reached in the Sixth and Ninth Circuits.

The Fourth Circuit stated the test for distinguishing between debt and equity capital in *Helvering v. Richmond F. & P.R. Co.*, 90 F.2d 971, 974 (4th Cir. 1937):

> "The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so they may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them."

Similarly, the Eighth Circuit in *Rowling-Moxley Co. v. United States*, 586 F.2d 723 (8th Cir. 1978) denied petitioner's claim for a bad debt deduction, characterizing the advances as capital contributions rather than bona fide loans, on the ground that "the advances were unsecured and payment was predicated entirely upon the venture's financial success."

The test for distinguishing between debt and equity capital applied by the Fourth, Fifth and Eighth Circuits is in direct conflict with decisions reached by the Sixth and Ninth Circuits in considering the same question. The Sixth Circuit expressly rejected the test applied in the Fourth, Fifth and Eighth Circuits in *Byerlite Corp. v. Williams*, 286 F.2d 285, 291 (6th Cir. 1960), stating:

> "But it does not help in the solution of the

> problem to speak of the man who invests in stock of a corporation as the one who takes the risks and the creditor as the one who seeks a definite obligation, payable in any event. One who makes a loan to a corporation also takes a risk, and while he may receive evidence of an obligation, payable in any event, often such obligation is never repaid."

In accord with the Sixth Circuit, the Ninth Circuit stated its position in *Earle v. W. J. Jones & Sons, Inc.*, 200 F.2d 846, 851 (9th Cir. 1952) stating:

> "To say that advances were 'gambled' and placed at the risk of business does not help. All loans involve more or less risk. On all available information, the risk here was a good one. And it cannot be said in contravention of the testimony at trial, that the holders...had no reasonable expectation that they'd be repaid."

II.

Another factor considered by the courts in differentiating between debt and equity capital is the availability of outside financing. In the instant case, the Fifth Circuit held that Station's and Land's advances to Computer were capital contributions rather than bona fide loans because third party loans were not "readily available" even though the corporate taxpayer proved a substantial third party loan was in fact made. This is an impractical concept; the wording of the test is inconsistent with the test as stated in the Second, Third, and Eighth Circuits and the effect is completely at odds with the purpose for considering the availibility of outside loans.

The purpose for considering the availibility of outside financing is to ascertain the economic reality of the transaction through an objective test, i.e. if no outside party is willing to make a loan to the corporation then an advance by a stockholder to the corporation takes on the appearance of a contribution to capital rather than a bone fide loan. *Fin Hay Reality Co. v. United States*, 398 F.2d 694 (3rd Cir. 1968). The test has thus been stated: "The ability of the corporation to obtain loans from outside lending institutions", *In Re Indian Lake Estates*, 448 F.2d 574 (5th Cir. 1971); "whether third parties would have made the loan under the same conditions", *In Re Uneco, Inc.*, 532 F.2d 1204 (8th Cir. 1976); "whether outside investors would have made similar advances", *Nassau Lens Co. v. Commissioner*, 308 F.2d 39 (2nd Cir. 1962); "the ability of the corporation to obtain funds from outside sources", *Fin Hay Reality Co. v. United States*, 398 F.2d 694 (3rd Cir. 1968).

The Fifth Circuit itself has been totally inconsistent in its application of the test. In *Tomlinson v. 1661 Corp.*, 377 F.2d 291 (5th Cir. 1967), the Fifth Circuit, in holding a bona fide debt had been created in the absence of third party financing, stated: "That outsiders offer credit only on prohibitive terms does not transmute a stockholder loan into equity capital." This statement is inconsistent with the Eighth Circuit's requirement that third parties would have made the loan under the same conditions. Similarly, in *Austin Village, Inc. v. United States*, 432 F.2d 741 (6th Cir. 1970), the Fifth Circuit denied the existence of a bona fide loan on the ground that the corporation was unable to obtain "sufficient" conventional financing, thus establishing the amount of available outside financing as a crucial factor whereas none of the above stated tests addresses such a consideration.

In the instant case, the Fifth Circuit had added yet another dimension to its test by requiring that third party financing be "readily available". This is an impractical concept far more stringent than that required by any of the above stated tests. The objective reality is that Greyhound extended its existing loan to Computer and further lent the company an additional $1,500,000.00. That outside financing was available cannot be questioned. Whether other lenders would also be willing to advance funds is totally irrelevant. The effect of the Fifth Circuit's test then is to render the reality of the transaction as meaningless.

III.

In the instant case, Stations and Land made advances to B&K partnership which expended some of the funds for the benefit of the corporation and the balance for the partnership's own purposes. The Fifth Circuit held that the use of the advances by the partnership could not be allocated, therefore no bad debt was incurred. This holding is a faulty statutory construction which will affect every corporate lender.

Internal Revenue Code Section 166(d) disallows a bad debt deduction for non-business debts in the case of a taxpayer "other than a corporation". Hence, by requiring a tracing of the use of advanced funds in the hands of B&K in order to establish a business purpose for the loan the Fifth Circuit erroneously applied the standard applicable to individuals to be satisfied by corporate taxpayers. Furthermore, a tracing of the use of funds in the hands of the debtor is an improper method of establishing a business purpose for loans. The Committee Reports issued in 1942 accompanying Section 166 emphasized: "the character of

the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the debtor."

For each of the above reasons it is respectively urged that the Supreme Court review the instant decision and articulate clear standards for establishing the existence of a bona fide loan eligible for a bad debt deduction.

CONCLUSION AND PRAYER

Because of the importance and broad application of these issues in Federal tax cases, the petitioner prays that this Court grant a Petition of Certiorari to the United States Supreme Court.

Respectfully Submitted,

TOWNER LEEPER
Attorney for Petitioner
661 Mesa Hills Drive
El Paso, Texas 79912

PROOF OF SERVICE

The undersigned attorney of record for Petitioner, PIGGY BANK STATIONS, INC., hereby certifies as follows:

(A) That I, Towner Leeper, am a member of the bar of the United States Supreme Court, and that I have duly served all parties required by the Rules of said Court to be served with the foregoing Petition for Writ of Certiorari, as hereinafter shown:

(B) That the names and addresses of the attorneys of record for the adverse party are as follows:

The Honorable Charles Fried
Solicitor General of the United States
Department of Justice
Washington, D. C. 20530

The Honorable Glenn L. Archer, Jr.
Assistant Attorney General
Department of Justice
Washington, D. C. 20530

Michael L. Paup
Carleton D. Powell
John P. Griffin
Attorneys
Tax Division
Department of Justice
Washington, D. C. 20530

(C) That on this day I serve three printed copies of the foregoing Petition for Writ of Certiorari on the said Charles Fried and the said Glenn L. Archer, Jr., Michael L.

Paup, Carleton D. Powell, and John P. Griffin, Attorneys for said Respondent, by depositing same in Emory Air Express, with prepaid express service, properly addressed to said attorneys for Respondent at their said addresses.

Executed, this 11th Day of June, 1985.

TOWNER LEEPER
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APPENDIX

Official Tax Court Syllabus

[1] Held: Various sums disbursed by petitioner were not made with an intent to create an indebtedness of the payee to the payor; therefore, petitioner was not entitled to claim bad debt deductions with respect to these disbursements.

Towner Leeper, for the petitioners.

William D. Peltz, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, *Judge*: Deficiencies were determined against petitioners as follows:

PIGGY BANK STATIONS, INC.

Tax Year Ended	Deficiency
November 30, 1969	$ 1,424
November 30, 1972	25,034
November 30, 1974	191,978
November 30, 1975	63,080

PIGGY BANK INC. AND SUBSIDIARIES

Tax Year Ended	Deficiency
October 31, 1976	$ 4,828

These deficiencies all result from disallowance of bad debt deductions, which had created net operating losses carried

back and forward to the years listed above. Bad debt deductions were claimed by Piggy Bank Stations, Inc. (Stations), in its fiscal year ending November 30, 1975, in the amount of $294,367, all of which is challenged by respondent. In its short fiscal year ending March 31, 1976, Stations deducted bad debts in the amount of $347,529. Respondent has conceded $26,424 of this amount, leaving $321,105 in dispute. Piggy Bank Land Company (Land) claimed a bad debt deduction in its short fiscal year ending March 31, 1976, in the amount of $8,500, all of which is in dispute. The following tables show as to each petitioner the components of the disputed bad debts, allocated into categories conforming to our findings of fact and the analysis of the applicable laws:

Table A
Allocation of Claimed Bad Debts in the Categories I, II and III

A. Stations' fiscal year 1975 bad debt write-off:

Category III	$294,367.00
Total for 1975 bad debts	$294,367.00

Stations' fiscal year 1976 bad debt write-off:

Category I	$ 55,234.65
Category II	244,870.35
Category III	21,000.00
Total for 1976 bad debts	$347,529.00
Conceded by respondent	$ 26,424.00
Disputed by respondent	$321,105.00

B. Land's fiscal year 1976 bad debt write-off:

Category II	$8,500.00
Total for 1976 bad debts	$8,500.00

TABLE B
Explanation of Categories

1. Distributions by Stations to Sam S. Klink on or about March 31, 1976, in connection with sale by him of the stock of Stations and Land:

Piggy Bank Stations, Inc.
Cite as ¶82,365 P-H Memo TC
Table B
Explanation of Categories

1. Assumption of debt of William A. Johnstone $4,588.11
2. Cash value of life insurance policy on Sam S. Klink owned by Stations 37,954.75
3. Distribution to Sam S. Klink of his vested interest in terminated profit-sharing plan 12,691.79

Total category I bad debts claimed by Stations in fiscal 1976 $55,234.65

II. Advances by Stations and Land to Browne & Klink partnership in connection with acquisition by Land of filling stations:

1. Advances by Land, claimed as bad debt in fiscal 1976 .....$8,500.00
2. Advances by Stations to Browne & Klink partnership in connection with acquisition by Land of filling stations, claimed as bad debts in fiscal year 1976 .....244,870.35

Total category II bad debts $253,370.35

III. Advances by Stations to or for the benefit of General Computer Service, Inc.:
1. Advances to Browne & Klink partnership earmarked

for General Computer Service Inc., and claimed as bad debt in fiscal 1976	$21,000.00
2. Advances to General Computer Service, Inc., claimed in fiscal 1975	294,367.00
Total category III bad debts	$315,367.00

Stations and land were until March 31, 1976, affiliated corporations, each being owned in equal shares by Sam S. Klink (Klink) and William A. Johnstone (Johnstone). Stations was an operator of gasoline stations, some of which were owned by it. Other filling stations were owned and leased to Stations by Land, and others were leased to Stations by unrelated parties. Klink handled financial matters for these corporations, while Johnstone concentrated on managing Stations' business.

Klink was also one of two equal partners in the Browne & Klink partnership (B & K), which was engaged in various land development projects. These projects included locating station sites and designing and constructing filling stations to be operated by Stations and in most cases to be owned by Land. The record does not disclose what compensation B & K received from Stations and Land for these services. Robert F. Browne managed the activities of B & K, and Klink handled its financial affairs.

General Computer Service, Inc. (Computer), was formed prior to 1972, at least in part at the insistence of Klink, to capitalize on computer programs which had been developed by two unrelated individuals, Johnstone and Stations' independent accountant to facilitate internal reporting and accounting control of Stations' business. Stations, Klink and Johnstone, among others, became stockholders in Computer.

All of these individuals and companies were residents of El Paso, Texas, during the periods of time here involved, and it is stipulated that petitioner corporations were residents of El Paso when the petitions herein were filed.

As of March 31, 1976, Klink and Johnstone sold their stock in both Stations and Land to petitioner, Piggy Bank Inc. (Purchaser), a new corporation which was formed by two individuals to effect this purchase. The sale was consummated on March 31, 1976, pursuant to a contract of sale between Klink and the two individuals. The filling station properties and most other assets were included in the 1976 sale, with Purchaser assuming liability for any indebtedness secured by any liens on the properties.

Respondent contends that none of the disputed amounts constitue bad debts, with alternative contentions as to the year in which the bad debts should be deemed worthless if determined by the Court to constitue bad debts.

Before we turn to an analysis of the particular purported bad debts, we note certain basic principles which are controlling here. It is well settled that whether or not advances or disbursements by a taxpayer are to be treated as debts for tax purposes is a question of fact to be determined on the basis of all the facts and circumstances. Many factors have been used by courts to assist in distinguishing debts from equity additions, constructive dividends, and gifts, no one of which is conclusive. *Gilbert v. Commissioner*, 262 F.2d 512 [3 AFTR 2d 456] (2d Cir. 1959), cert. denied 359 U.S. 1002 (1959). It is also hornbook law that the substance rather than the form of the transaction will be looked at for tax purposes. *Gregory v. Helvering*, 293

U.S. 465 [14 AFTR 1191] (1935). In dealings between related parties, the characterization by the parties of a transaction is "to be recognized or disregarded for tax purposes according to the extent to which they [the parties] comply with arm's-length standards***." *Nassau Lens Co. v. Commissioner*, 308 F.2d 39, 46 [10 AFTR 2d 5581] (2d Cir. 1962), remanding 35 T.C. 268 (1960).

The taxpayer has the burden of establishing the debt characterization. See, e.g., *Jewell Ridge Coal Corporation v. Commissioner*, 318 F.2d 695 [11 AFTR 2d 1663] (4th Cir. 1963), affg. a Memorandum Opinion of this Court; *Gilbert v. Commissioner, supra; Saigh v. Commissioner*, 36 T.C. 395 (1961). We conclude that petitioners have not met their burden of proof. While each of the different categories of disbursements requires a slightly different analysis, we find as to each category the same ultimate fact—the disbursements were not made with the intent to create an indebtedness of the payee to the payor.[1]

Category I Bad Debts

The sale of Stations and Land was handled in two steps. First, Klink purchased Johnstone's interest in each corporation for cash. Then Klink sold all of the shares of stock to Purchaser for cash, with most of the cash being paid to secured creditors of Klink. Both Johnstone and Klink received distributions from Stations' profit-sharing plan which was terminated, apparently in contemplation of the sale. Klink's distribution, but not Johnstone's, was

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[1] While the transfer by Stations to Klink of the insurance policy on his life technically was not a disbursement of funds, we have treated it for convenience as equivalent to a cash disbursement of the cash surrender value since the parties have done so.

was treated as an advance to B & K (one of the category I items) and was included in Stations' fiscal 1976 bad debt deduction. A policy of life insurance on Klink's life which was owned by Stations was, pursuant to the contract with Klink, distributed to him. The cash surrender value was also treated as a bad debt owing to Stations. Also in connection with the consummation of the sale and to settle dispute as to whether Johnstone should have repaid to Stations the additional sum of $9,176.22, Klink agreed to assume an obligation for one-half of that sum of $4,588.11. (This constitutes the third category I item). The record does not disclose how or whether this sum was actually paid to Stations but out of Klink's share of the sale proceeds, the sum $6,981.51 was paid to Stations to pay "personal bills." Both Klink and B & K were insolvent at this time. At some later time, Johnstone purchased from Stations certain life insurance policies on his life.

Little discussion is required with respect to the transfer to Klink in connection with the sale of the stock in Stations and Land of the insurance policy on his life. Such disposition of this type of corporate asset is a common occurrence where the ownership of a closely held corporation changes hands. The corporation would have no use for the policy except to realize its cash surrender value when the insured employee terminated his employment. The distribution by the corporation of an asset to a shareholder-employee or a former shareholder-employee without any ocnsideration flowing to the corporation would be expected to have some tax consequence. Economically and realistically, the cash surrender value added to the consideration received by Klink for the sale of the stock of Stations. The withdrawal of this asset might have been treated as a dividend to Klink or to Purchaser, perhaps depending

upon timing. But without question, this transaction could not and did not create an indebtedness of B & K to Stations. Neither did Klink thereby become indebted to Stations. The transfer was pursuant to an express provision of the contract of sale between Klink and Purchaser. The somewhat loose language in the supplemental stipulation of facts cannot create a debt where none existed. We find and hold that the cash surrender value of this policy did not become a debt owing Stations.

The record is devoid of any description of the pension and profit-sharing plan except for the facts recited in the copy of Stations' fiscal year 1972 Federal income tax return. There the plan is described as a profit-sharing plan qualified under section 401.[2] In the absence of facts to the contrary, we will assume that the plan continued as a qualified profit-sharing plan up to its termination in connection with the sale of stock in 1976. Upon that event the plan assets vested (if not already vested) and were required to be distributed to the plan participants, including Klink and Johnstone. Section 411(d)(3). There is nothing to indicate that Stations, either before or after the sale of its stock, had any claim to the assets in the profit-sharing plan. Here also, the facts simply preclude the treatment of this distribution to Klink of plan assets as an indebtedness owned by B & K or him to Stations. The distribution would have tax consequences to Klink but he is not before this Court.

The remaining category I item is one-half of an alleged debt of Johnstone to Stations, which arguably should have been paid to Stations by Johnstone out of his share of

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[2] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended.

the cash paid for his Stations stock. Petitioner argues that this was a valid debt of Johnstone, which to the extent of $4,588.11 according to the stipulation was "assumed" by Klink. Since Klink was insolvent, petitioner disposes of this issue on the ground that respondent is bound by the stipulation. We have found there was a dispute as to this indebtedness of Johnstone to Stations and that Klink assumed one-half of the amount. The facts are incomplete on this issue, as on most other issues in this case. We conjecture that the assumption by Klink "To avoid upsetting the sale***," as stipulated by the parties must have involved Purchaser, which knew at the time that Klink was insolvent. We can further surmise that this sum was included in the personal bills of Klink which were repaid to Stations out of sale proceeds. That is the only logical construction of the events, but we cannot find such facts on this record. However, there is nothing to indicate that this sum became part of an indebtedness of B & K to Stations.

The inclusion of these three category I items in Stations' bad debt write-off appears at best to have been a frivolous claim even though surprisingly respondent has not so treated it. Petitioners clearly have not proven that any of these three items constitued an indebtedness of B & K due to Stations which existed after the consummation of the sale. We hold for respondent on these three issues.

Category II Bad Debts

Funds to pay the costs incurred by B & K in the building design and construction of filling stations to be operated by Stations were generally advanced by Stations to B & K, but in one instance were advanced by Land. These funds were treated for book purposes when advanced

as receivables owed by B & K to Stations or to Land which were to be cancelled or repaid out of permanent financing obtained from unrelated parties.[3] The balances in these accounts on the books of Stations and Land were written off as bad debts as of March 31, 1976, the date these corporations were sold.

Petitioners' treatment of these so-called advances from Stations and Land to B & K which were used to defray the acquisition cost of new filling stations does not stand on a much stronger footing than their position with respect to the insurance policy, the profit-sharing plan distribution and the Klink assumption.

Since the facts are more complete with respect to the $8,500 claim of Land, we take that as the best paradigm of the parties' practices. On various dates starting on June 7, 1966, through December 15, 1966, relatively small amounts of cash were apparently deposited by Land to B & K's account. On December 31, 1966, the sum of $25,000 was transferred to B & K with a journal entry description of "Construction advance on Las Cruces Station." Also on the same date two other journal entries show as debits to the account, the sum of $2,000 described as "Reduce advances on Las Cruces Station" and the sum of $35,500 described as "Income due on construction." Two further small cash deposits were made to the B & K account, one in January 1967 and the second in March 1968, leaving a credit balance of $8,500 of Land's books. The record does

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[3] It is not clear from the record how and by whom land costs were paid and when title passed to Land or Stations. Such costs apparently were not included in the so-called advances to B & K. Neither is it clear how such third party financing was handled, but the obligation to repay such lenders must have been that of Stations and Land.

not indicate whether any of the "deposits" were derived from permanent financing. Also, the record fails to show what cost for this station was capitalized on Land's books and whether or the extent to which journal entries in the capital accounts of Las Cruces station correspond to the entries in the B & K advance account, but based on the record we must assume that there would be a correlation. There is nothing whatsoever in the record to indicate that there was at any time between June 7, 1966, and March 21, 1968, any intent on the part of either party that the excess of the advances over the items reducing the advances constituted an indebtedness of B & K to Land except the bare fact that Land apparently treated the transaction on its books for some purposes as an account receivable. There was no repayment by B & K of any part of this sum during the eight-year period between the March 1968 advance and the sale of the Land in March 1976, and we must assume that B & K was solvent during most of this time. There was no agreement as to interest. And of even greater significance, the testimony is that repayment, or perhaps more properly the liquidation, of the so-called receivable was intended to be made out of permanent financing from third parties. At least that was the practice.

While much is left to conjecture on this record, we find no basis for characterizing this $8,500 item as a debt out-standing in 1976.[4] It is more reasonable to conclude that Land's cost for work by B & K on the Las Cruces filling station was $46,000 the aggregate of the advances. Petitioners have not sustained their burden of proof with respect to the $8,500 item.

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[4] Compare *Gutierrez v. Commissioner*, 53 T.C. 394 (1969), affd. per order (D.C. Cir. Dec. 9, 1971).

With respect to the additional so-called advances by Stations to B & K amounting to $244,870.35 in connection with the acquisition of new filling stations, the testimony shows, and we find, that the transactions were handled in a similar fashion to Las Cruces Station except for the inability of the parties to obtain third-party financing for some of the stations because of the economic situation during the years 1973 and 1974. This circumstance can have no bearing on whether or not the advances by Stations to B & K should be characterized as loans. There was no agreement as to an interest rate or as to repayment dates or even as to an obligation of B & K to repay. According to the testimony, repayment was to be made out of third-party financing with the necessary implication that Stations or Land would be responsible for repayment to such lenders. It is true that Johnstone and Klink both testified that they expected Stations would be repaid for these advances, but each also testified that the advances were made to defray B & K's costs. Johnstone stated: "They [B & K] were building those stations for us and we'd advance them money. When the loans would come through they were handled by the accountant, credit or debit." There was no mention of fixed price contracts with B & K, or that the unpaid receivables constituted advances in excess of an agreed upon cost. Petitioners have failed to prove that these category II sums constituted debts owing by B & K to Stations and to Land, respectively. We hold for respondent on these issues.

Category III Bad Debts

As we analyze this case, it is only with respect to the disbursements by Stations to or for the benefit of Computer that any legitimate question can arise as to the creation of an indebtedness.

Several years prior to the period involved here, two unrelated individuals interested Johnstone in a computer program to assist Stations in promptly deriving necessary financial reports of the filling station activities. After some refinement of the program through the efforts of Johnstone and others, Klink became interested in attempting to merchandise the program. For this purpose Computer was formed, with the stock being held by various individuals, including Klink, Johnstone and the two men who first brought the computer program to Johnstone. Stations also became a shareholder, apparently by conversion of a portion of its initial advances into stock. Computer was substantially undercapitalized from its inception.

From some time before December 31, 1972, through December 1974 the operating expenses of Computer were paid in whole or in part with funds derived from Stations. Advances were in part made directly to Computer and in other instances to third parties for expenses incurred on behalf of Computer. Some of the advances were reflected by promissory notes payable on demand and some were simply carried as receivables.[5] No payments of interest or principal were made on any of these notes or advances. These notes and advances aggregated $294,367 by the end of Stations' 1975 fiscal year, which sum was written off as a bad debt on Stations' fiscal 1975 tax return.

An additional sum of $21,000 was advanced by Stations for the benefit of Computer. This amount was actually advanced to B & K and by it disbursed for or to Com-

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[5] The first note, dated December 31, 1972, reflected prior advances aggregating in excess of $62,000, approximately $19,000 of which was at that time converted into common stock issued to Stations and the balance into this note.

puter. The claimed worthless bad debt owed by B & K in the amount of $321,105 included this sum. The record does not indicate when this advance, or series of advances, was made but it must have occurred prior to January 3, 1975, when Greyhound Computer Corporation (Greyhound) took over Computer's business. The record does not expalain why B & K was injected into this picture. The stipulation recites that:

> 32.*** It also includes an amount of $21,000, set out on the books of Stations as being an advance to General Computer but carried in the B & K account because it was advanced to B & K and spent by B & K on behalf of General Computer.***

We find on this record that B & K acted simply as a conduit. This sum should be classified and treated in a manner identical to the sums advanced by Stations directly to or for the benefit of Computer.

During this period, 1972-1974, Computer incurred substantial amounts of secured and unsecured indebtedness, including a Small Business Administration loan totaling more than $300,000, which required that some shareholder advances be subordinated. Almost $500,000 of unsecured notes of Computer were guaranteed by certain stockholders, and $300,000 on an unsecured note payable to Greyhound was also guaranteed by certain stockholders. Much of this indebtedness was shown as past due on Computer's balance sheet for October 31, 1974, as well as its balance sheet for October 31, 1975. By the end of its 1974 fiscal year, net operating losses of almost $300,000 had been incurred.

On January 3, 1975, a contract was entered into with Greyhound pursuant to which all of the business and assets were transferred to Greyhound except for certain sums due under land contracts, in return for royalties. By May or June of 1975, Greyhound advised Klink and others that it would exercise its option to terminate its contract with Computer and the termination was actually effective in early 1976. This ended any possible hope of Computer becoming profitable.

The formation of Computer had no essential relation to the business purposes of Stations. It was not until after Stations had developed the computer programs to the point that they were working satisfactorily for Stations that the idea of merchandising those programs to third parties came into being. The incorporation of Computer was not necessary for Stations to utilize the software developed in part by Johnstone. It is not even clear from the facts that Stations could not have provided all of the computer service it needed itself through its own resources.

Klink exercised unfettered control over the finances of Stations, Land and B & K and freely withdrew funds from Stations for Computer's benefit, some of which were, as we have found, channeled through B & K. The manner in which Klink handled the partial financing of Computer out of Stations' excess capital suggests characterization of the advances as constructive dividend distributions to him.[6] Johnstone testified, for example:

Q Did he [Klink] ever consult with you?

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[6] Apparently, on Stations' books the advances to Computer were recorded as due from "one of the principal officers," presumably Klink.

A He'd give a check—oh, yeah, he'd tell me what he was doing. Most of the time—I mean, we weren't working together. I might be gone or anything. And if he needed the money, he drew the money. We'd see each other, have meetings, and then I was informed.

Q And when he did this, it met with your approval?

A Yeah, it was all right. He was a 50-50 partner.

* * * * * * * * * *

Q Did there come a time when you became concerned about the amount of money that was being taken from Stations and being invested in General Computers?

A Well my only objection was, Sam taking the money, was we were constantly in a cash bind, you know, to pay our own bills. That was my concern. But as far as him utilizing the money, I mean, half of it was his money.

Respondent has not, however, pressed his analysis. Rather, respondent contends that these so-called advances were captial investments and in any event were not debts for tax purposes. We agree that petitioners have not shown that an indebtedness for tax purposes was created.

Among the factors which we consider most critical in determining whether an advance should be characterized as a loan are the presence or absence of an agreement as to interest, the payment of interest and principal, the existence of an immediate ability to repay an advance, the furnishing of collateral or other security for the advance

and whether or not an unrelated third party would have made a loan under the circumstances. *Jewell Ridge Coal Corporation v. Commissioner*, 318 F.2d 695 [11 AFTR 2d 1663] (4th Cir. 1963), affg. a Memorandum Opinion of this Court; *Nassau Lens Co. v. Commissioner*, 308 F.2d 39, 46 [10 AFTR 2d 5581] (2d Cir. 1962), remanding 35 T.C. 268 (1960). The fact that the advances were entered on the parties' books as loans is not conclusive. *Road Materials, Inc. v. Commissioner*, 407 F.2d 1121 [23 AFTR 2d 69-859] (4th Cir. 1969), remanding on other grounds a Memorandum Opinion of this Court. Neither is the characterization by the parties in testimony given at a later date of much assistance when it is not buttressed by evidence of contemporaneous facts. *Road Materials, Inc. v. Commissioner, supra.*

Petitioners have emphasized that Computer was undercapitalized from the start, a factor tending towards characterization as equity rather than debt. *Montclair, Inc. v. Commissioner*, 318 F.2d 38 [11 AFTR 2d 1523] (5th Cir. 1963; *Rowan v. United States*, 219 F.2d 51 [46 AFTR 1636] (5th Cir. 1955). Of significance also is the fact that Computer was never profitable and was insolvent when most if not all of these advances were made. The record shows that much of the stockholder indebtedness was directly or by implication subordinated to other loans.

While the record does not reveal which stockholders were required to subordinate their indebtedness and which were required to guarantee loans by others, it seems more than probably that with Klink's heavy participation in financial activities and his status as the largest single shareholder of Computer, he must have been one of those required to subordinate and to join in the guaranties. It is

a safe assumption also that such action by him extended to Stations' advances since Stations was the third largest shareholder. It is inconceivable that any unrelated party would have made a subordinated loan without collateral to Computer under these circumstances, a fact strongly indicating the advances were not loans. *See Tomlinson v. 1661 Corporation*, 377 F.2d 291, 298 [19 AFTR 2d 1413] (5th Cir. 1967). At some point either in late 1973 or early 1974, Computer was in fact unable to obtain additional financing from any outside sources.

We are not unmindful of the fact that between December 31, 1972, and August 5, 1974, Computer executed seven promissory notes, payable on demand with 10 percent interest, aggregating $188,338.52. But on October 23, 1973, ans during February 1974, there were also two advances to Computer, each in the amount of $50,000. No reason for the failure to evidence these two advances by notes is given. Thereafter, between August 1974 and December 1974, the aggregate of $6,028.48 was disbursed to various unrelated parties apparently for Computer's benefit. Finally, at some time or times prior to December 1974, the aggregate sum of $21,000 was disbursed by B & K on behalf of Computer out of funds supplied to B & K by Stations for that purpose. There is no evidence that Computer had the financial capability of repaying any of these advances when made, whether or not evidenced by a note. The only hope of repayment was profitability at some indeterminate time in the future, and this gamble upon possible future earnings does not warrant finding the advances to be debts. *See Funk v. Commissioner*, 35 T.C. 42, 50 (1960).

Petitioners argue that Computer was not thinly

capitalized, pointing only to evidence of its capitalization on December 31, 1974. This may be correct as of that date, but it is not only undisputed but forcefully argued by petitioners that Computer was undercapitalized from its organization. Some of the equity was derived from the conversion of advances, which apparently was the origin of Stations' equity interest. Almost $1,500,000 was created during 1974 in connection with some acquisitions. It is evident that at the commencement of Stations' financing of Computer, and apparently throughout the period of Computer's business activities, Klink recognized that no current repayment was possible. That depended finally upon Greyhound's success after it acquired the sofware operations.

Petitioners emphasized on brief *American Processing and Sales Co. v. United States*, 178 Ct.Cl. 353, 371 F.2d 842 [19 AFTR 2d 533] (1967) and *Byerlite Corporation v. Williams*, 286 F.2d 285 [6 AFTR 2d 6069] (6th Cir. 1960), but we believe the opinion of the Fourth Circuit in *Road Materials, Inc. v. Commissioner, supra.* properly distinguishes the facts in this case. There was no business reason for Stations' advances and none of the advances were repaid.[7]

We are again forced to conclude that petitioners have not satisfactorily demonstrated on this record that the advances to and for the benefit of Computer constitute indebtedness for Federal tax purposes.

Decisions will be entered for the respondent.

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[7] We do not consider the reorganization of Stations' first block of advances into a combination of stock and a demand note to constitute a repayment.

UNITED STATES TAX COURT

PIGGY BANK STATIONS, INC.,	)	
Petitioner,	)	
	)	
v.	)	Docket No.
	)	1471-79
COMMISSIONER OF INTERNAL REVENUE	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed November 3, 1983, and incorporationg herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income taxes due from the petitioner for the taxable years ended Nevember 30, 1969, November 30, 1972, Novebmer 30, 1976, and November 30, 1975, in the amounts of $1,423.00, $25,034.00, $180,788.00, and $63,000.00, respectively.

/s/ Meade Whitaker
Judge

Entered: Jan, 1984

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

/s/ Towner Leeper
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UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

PIGGY BANK INC.
AND SUBSIDIARIES
Petitioner,

V. Docket No. 1549-79

COMMISSIONER OF
INTERNAL REVENUE
Respondent.

DECISION

Pursuant to the determination of this Court as set forth in its Supplemental Memorandum Findings of Fact and Opinion filed November 3, 1983, it is

ORDERED and DECIDED that there is a deficiency in income tax due from petitioners in the amount of $4,828.00 for the taxable year ended October 31, 1976.

/s/ Meade Whitaker
Judge

Entered: JAN 1984

Official Tax Court Syllabus

[1] Held:This Court's holding in original opinion confirmed on the basis of the additional evidence received upon reopening the record.

Towner Leeper and David Leeper, for the petitioners.

David W. Johnson and Ana G. Cummings, for the respondent.

SUPPLEMENTAL MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, *Judge:* On June 28, 1982, we entered our Memorandum Findings of Fact and Opinion and on June 29, 1982, a decision was entered in each docket. There after, petitioners filed motions to vacate decision and for reconsideration of findings of fact and opinion, together with motions for review by the full Court or for a rehearing. By order dated August 5, 1982, the motions to vacate decision in each docket were granted. By order dated August 13, 1982, petitioners' motions for review by the full Court were denied.

By order dated January 26, 1983, the record was reopened for further testimony be deposition, limited, however, to the issue described in our Memorandum Findings of Fact and Opinion as the "Category II Bad Debts" issue, thus granting petitioners' motion for reconsideration of the findings of fact and opinion and for rehearing as to said Category II Bad Debts issue only and denying said motions as to all other issues. This issue involves the claimed bad debt deduction of Piggy Bank Land Company

(Land) in return for its short fiscal year ending March 31, 1976, in the amount of $8,500 and the claimed bad debt deduction of Piggy Bank Stations, Inc. (Stations), in its return for its short fiscal year ending March 31, 1976, in the amount of $244,870.35.[1] The record on the original hearing, including the original and supplemental stipulations and our June 28, 1982, Memorandum Findings of Fact and Opinion are incorporated herein by reference. The fact set forth in the stipulation of facts on deposition are found as stipulated, respondent's several objections being overruled. The Supplemental Findings of Fact and Opinion with respect to our reconsideration of the Category II Bad Debts issue are combined for convenience.

Stations' Category II Bad Debts

Based on the supplemental evidence, we find that the Categorry II Bad Debts deduction in the amount of $244,870.35 is composed in part of construction advances made by Stations to Browne & Klink (B & K) in connection with the construction or modification of filling stations and as a new issue[2] in part of funds transferred by Stations to B & K for use by B & K in its general land development business, as distinguished from its work on filling stations for Stations or Land.[3] The original record failed to disclose

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[1] Stations' total bad debt deduction for fiscal year 1976 was $347,529, of which $26,424 was conceded by respondent, $55,234.65 was described by us in our June 28, 1982, opinion as Category I Bad Debts, and $21,000 as Category III Bad Debts.

[2] There is an obious question as to the propriety of raising this new issue on this supplemental hearing but we have, nevertheless, given it all the consideration which the record allows.

[3] Stations was in the business of operating gasoline filling stations, some of which it owned, some of which were owned by Land and

the fact of this second purpose for some of the advances or transfers of funds to B & K. In the supplemental record there is no evidence which would allow us to determine or even to estimate that portion of the aggregate Category II amount which is referable to each of these two purposes. Such determination would be essential in order for us to find for petitioners on this aspect of the Category II Bad Debts issue and thus for the reasons set forth below we here reaffirm our holding for respondent upon the construction advance aspect of the issue. Whether or not funds transferred by Stations to B & K for use in the general land development business of B & K constituted an indebtedness which became worthless upon the insolvency of B & K would in any event be far from clear even if there were sufficient facts to enable us to segregate the amounts.[4]

(footnote 3 continued)
leased to Stations, and some of which were leased by Stations from third parties. B & K was engaged in various land development projects and as a relatively small part of its business in designing, building or modification of gasoline filling stations for Stations and Land, as well as locating potential sites therefor and negotiating the acquisition of sites for Stations and Land.

[4] At various times, B & K participated in the early developmental stages of two shopping centers, one known as the West Town Shopping Center and the other as the McRae site. Petitioners argue that Stations' loans to B & K to provide funds for land development for shopping centers such as these had a business purpose from Stations' standpoint since B & K hoped to be able to "spin off" to Stations' sites for filling stations. Again, however, no specific advance is linked to any acquisition by B & K of an interest in a potential land development site out of which a potential filling station location was spun off or even designated on a development plan for filling station usage. For example, a feasibility study procured by B & K with respect to the proposed West Town Shopping Center recites that no provision is made for convenience stores or service functions which would be constructed on the fringes of

There is testimony that demand notes were executed by B & K and presumably delivered to Stations, but the evidence as to notes is too indefinite and incomplete to enable us to make any finding with respect thereto.[5] The transfer of funds by Stations to B & K for use in B & K's general land development business presents entirely distinct considerations from the construction advances made in connection with the construction or modification of filling stations. Since we do not have evidence as to the aggregate amounts advanced for B & K's general land development business or any facts as to circumstances under which any specific transfer of funds was made by

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(footnote 4 continued)
the area, but fails to even mention filling stations as one of the illustrations of a fringe business. Klink did testify that a corner in the McRae site was transferred to "Piggy Bank" but the record is silent as to the date of the occurrence, whether a filling station was constructed or the relationship between one or more advances to B & K and the acquisition of the McRae site. We simply cannot base a finding of business purpose for a series of loans on vague, self-serving testimony such as this. *See South Texas Rice Warehouse Co. v. Commissioner*, 366 F.2d 890, 897 [18 AFTR 2d 5517] (5th Cir. 1966), affg. 43 T.C. 540 (1965), cert. denied 386 U.D. 1016 (1967). We also commented in our original opinion on the apparent free use by Mr. Klink of funds of Stations and Land for any purpose of interest to Mr. Klink.

[5] There was no evidence in the original hearing as to such notes and in fact no suggestion that some part of the $244,870.35 represented transfers of funds for use by B & K for its general business puposes. No notes were produced during the deposition or included in the record and there is no evidence as to dates, amounts or the disposition of any notes. Moreover, the deponent, Sam Klink, was himself unsure of the timing of the execution of notes and whether the notes included both advances for filling station construction and for other B & K business or only the latter. In any event, such notes, to the extend they existed, appear to have been intended to record historical events, executed after the fact, and apparently reflecting the account receivable balance at a particular time with no reference or relation to specific advances for specific purposes. *See South Texas Rice Warehouse Co. v. Commissioner, supra.*

Stations for either purpose,[6] there is simply no basis on this record for our consideration of this new issue. To the extent, therefore, that some portion of the Category II amount of $244,870.35 may have involved funds transferred by Stations to and used by B & K for its general land development business, petitioners have failed to carry their burden of proof that such amounts constituted an indebtedness which was properly charged off during Stations' 1976 fiscal year. Rule 142(a), Tax Court Rules of Practice and Procedure; *Welch v. Helvering*, 290 U.S. 111 [12 AFTR 1456] (1933).

Some portion of the Category II amount unquestionably was transferred by Stations to B & K as construction advances in connection with the modification, construction, reconstruction or equipping of one or more filling stations for operation by Stations. Filling stations were acquired under varying arrangements. Some stations were constructed on land owned by either Stations or Land and in other instances on land leased from third parties. B & K did not take title to land on which a station was to be built. Where land was leased, in some instances a complete filling station had to be constructed by Land or Stations. In other instances, the land and a structure were leased, but equipment had to be installed and possibly the structure modified or renovated. In some instances, the landlord turned over a completed property which may or may not have been constructed by B & K. In other instances, the lessee leased the land, the building and some equipment but other equipment had to be installed by Stations or Land. In all but one instance, work involved in completion

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[6] The only series of advances which is documented in any detail are those which resulted in the $8,500 alleged bad debt owed by B & K to Land.

of the filling stations was done by B & K as the general contractor. The work was done pursuant to a "cost-plus contract" which provided that Stations or Land would pay for the actual costs incurred by B & K plus 10 percent of the costs for its profit and 5 percent of the costs to reimburse B & K for administrative expenses. Construction money was advanced to B & K apparently as construction progressed, which we judicially know to be a customary arrangement in the construction industry. B & K and Land or Stations, as appropriate, recorded these construction advances on their respective books as accounts receivable.[7] That bookkeeping treatment is not, however, sufficient to create a bona fide indebtedness between the parties. *Road Materials, Inc. v. Commissioner*, 407 F.2d 1121 [23 AFTR 2d 69-859] (4th Cir. 1969), remanding on other grounds a Memorandum Opinion of this Court; *Nassau Lens Co. v. Commissioner*, 308 F.2d 39, 46 [10 AFTR 2d 5581] (2d Cir. 1962), remanding 35 T.C. 268 (1960)

A construction advance, sometimes referred to as a "progress payment," in a cost plus a fixed fee contract is designed to reimburse the general contractor pro tanto for at least a part of his out-of-pocket costs and/or his fee. Frequently, such advances are made against an architect's or engineer's certification as to the progress of work and payment for labor and materials. While the contractual arrangements between B & K and Stations or Land appear to have been less formal than is customary and the contracts probably oral rather than written, we must assume, in the absence of evidence to the contrary, that the arrangements between the owner and contractor in general followed the

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[7] Some notes may have been executed but, as pointed out above, we can make no specific findings in this regard.

normal pattern, which clearly is accepted and followed in the State of Texas.

> We agree with the State that the word "advance," in its strictly etymological significance, has an ordinary, common and well known meaning in both common parlance as well as in the commercial world. It indicates money was paid before or in advance of the proper time for payment, and implies a looking forward to a time when the money will be due the recipient.*** (*Keagan v. State*, 618 S.W.2d 54, 57 (Tex. Crim. App. 1981).) See also 2 C.J.S. Advance (1972).

The supplemental record clarifies the original record in that permanent financing of the filling station costs was obtained, when obtainable, either by Stations or Land but not by B & K. We are not informed as to the mechanics pursuant to which the permanent financing so obtained resulted in reduction or elimination of the receivable on the books of B & K referable to a particular filling station. However, there was no intent on the part of B & K that such advances, whether made by Stations or Land, would create a debt to be repaid by B & K.[8] B & K's repayment

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[8] See deposition of Sam Klink, filed August 15, 1983, pp. 30 and 31:

Q (BY MR. JOHNSON:) Was it the intention of Browne and Klink that the advances that were received from Piggy Bank Stations or Piggy Bank Land be maybe [sic] reduced when this permanent financing was obtained by Piggy Bank Land or Piggy Bank Stations?

A All the funds concerning Piggy Bank, yes.

Q The advances?

A The funds that were given to Browne and Klink, that didn't pertain to the particular station, Browne and Klink intended to pay it, yes. Is that what you are asking?

Q Well, the advances that were received from Piggy Bank Stations and Piggy Bank Land for the purpose of financing the initial stages of construction, that is what I am referring to.

obligation was limited to those funds transferred to it for use in its general land development business—the new issue.

It is obvious, and the Court judicially knows, that construction advances made by an owner to a general contractor in a cost-plus contract arrangement do not and cannot create any indebtedness by the general contractor to the owner in normal circumstances. To the extent that the aggregate of construction advances under such a contract do not exceed cost plus the agreed upon fee, and the contractor completes construction in accordance with the contract, the construction advances simply represent advance payments, i.e., payments as the work progresses, to the contractor of the agreed upon consideration, the contractor's costs plus the fee. It is at least theoretically possible for an owner to over-advance under a cost-plus contract in which event the contractor would have an obligation to refund the excess moneys. Also, a breach of contract such as by failure of the general contractor to complete could result in an obligation to restore to the owner construction advances in whole or in part. However, there is no evidence in this record which even hints at any such factual situation. The supplemental record simply confirms the conclusion reached by us in our original opinion that no part of the Category II bad debts referable to filling station work (the $8,500 balance on Land's books and that portion of the $244,870.35 in Stations books referable to construction advances) arose out of an indebtedness of B & K to Stations

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(footnote 8 continued)

A Yes.

Q Was it the intention of Browne and Klink that these advances would be paid from the permanent financing once it was obtained by Piggy Bank Stations or Piggy Bank Land?

A Yes.

or Land. We, therefore, confirm our holding for respondent on this issue in each docket.

Petitioners have inserted into the record evidence as to the audit of Sam and Vona Klink and of the B & K partnership, which resulted in a petition pending in this Court by Mr. and Mrs. Klink, docket No. 6443-80. This evidence forms the basis for petitioners' argument that respondent has taken inconsistent positions, thereby canceling the normal presumption of correctness attached to the statutory notice in this case. The inconsistency arises out of the fact that in these consolidated cases respondent disallowed the bad debt deduction claimed by Stations and Land for advances to B & K on the grounds, among others, that no indebtedness existed, whereas in docket No. 6443-80, respondent did not challenge the existence of the B & K debt as claimed by the partnership but instead asserted that its write-off resulted in income to B & K, thus challenging the insolvency of B & K. Petitioners rely on *Helvering v. Taylor*, 293 U.S. 507 [14 AFTR 1194] (1935); *Meyer v. Commissioner*, 46 T.C. 65 (1966); *Nat Harrison Associates, Inc. v. Commissioner*, 42 T.C. 601 (1964); and *Doggett v. Commissioner*, 66 T.C. 101 (1976).

Petitioners' reliance upon these cases is misplaced. Respondent is not seeking to tax the same income twice. To the extent that the position of respondent in docket No. 6443-80 may be said to be inconsistent with his position in these dockets, and it is certainly not inconsistent within the language of our opinion in *Doggett v. Commissioner*, *supra* at 104, we find respondent's positions to be reasonable, with no shadow of the type of arbitrary and capricious action which the Court in *Helvering v. Taylor*, *supra*, criticized. Neither the burden of proof nor the

burden of going forward with the evidence is shifted to respondent in this case.

By reason of respondent's concession in Piggy Bank Stations, Inc., docket No. 1471-79, decision in that docket will be entered under Rule 155.

In the case of Piggybank, Inc. and Subsidiaries, docket No. 1549-79, decision will be entered for the respondent.

A-33

PIGGYBANK STATIONS, INC.
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 84-4042

United States Court of Appeals, Fifth Circuit.
March 21, 1985.

Appeal from the United States Tax Court.

Before GEE, WILLIAMS and JOLLY, Circuit Judges.

GEE, Circuit Judge:

Piggy Bank Stations, Inc. (Stations) and Piggy Bank, Inc. brought an action in the United States Tax Court contesting the assertion of income tax deficiencies against them by the Commissioner of Internal Revenue (the "Commissioner"). The tax court held for the Commissioner. We affirm.

I.

Sam S. Klink and William Johnstone owned equal shares of two affiliated corporations, Piggy Bank Land, Inc. (Land) and Stations. Stations operated gasoline stations and owned some of the stations it operated. Land owned and leased other filling stations to Stations, and still other filling stations were leased to Stations by unrelated parties. Klink handled the financial matters of the Piggy

Bank corporations, while Johnstone concentrated on managing Station's business.

Klink was also one of two equal partners in the Browne & Klink partnership (B & K), which was engaged in various land development projects. These projects included locating stations sites and designing and constructing filling stations to be operated by Stations and in most cases to be owned by Land. Robert F. Brown managed the activities of B & K, and Klink handled its financial affairs.

General Computer Service, Inc. (Computer) was formed to market computer programs that originally had been developed to facilitate internal reporting and accounting control of Stations' business. Stations, Klink, and Johnstone, among others, became stockholders in Computer.

In March 1976, Klink purchased Johnstone's interests in Stations and Land for cash. Then Klink sold all of the Stations and Land stock to a newly formed corporation, Piggy Bank, Inc. The new owner of Stations and Land claimed various deductions for bad debts. The Commissioner disallowed these deductions and assessed deficiencies against Stations and Land. Stations and Land challenged the Commissioner's ruling in the tax court. The tax court upheld the Commissioner's ruling, and this appeal followed.

II

[1,2] Before analyzing the particular purported bad debts, we note certain principles that control this case. Internal Revenue Code (IRC) § 166(a) provides: "[t]here shall

be allowed as a deduction any debt which becomes worthless within the taxable year." to be deductible under § 166(a), the debt must be bona fide:

> *Bona fide debt required.* Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.... A gift or contribution to capital shall not be considered a debt for purposes of section 166. The fact that a bad debt is not due at the time of deduction shall not of itself prevent its allowance under section 166.

Treas.Reg. § 1.166—1(c). The question whether payments or disbursements by a taxpayer are to be treated as debts for tax purposes is an issue of fact, and we will not disturb the Commissioner's finding on such issues unless the finding is clearly erroneous. *Estate of Mann v. United States*, 731 F.2d 267, 273 n. 8 (5th Cir.1984). *See also Brimberry v. Commissioner*, 588 F.2d 975, 977 (5th Cir.1979); IRC § 7482(a).[1] The taxpayer has the burden of establishing the bad debt characterization. *Mann*, 731 F.2d at 273 n. 8; *Byram v. Commissioner*, 555 F.2d 1234, 1236 (5th

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[1] Section 7482(a) provides:

Jurisdiction. The United States Courts of Appeals (other than the United States Courts of Appeals for the Federal Circuit) shall have exclusive jurisdiction to review the decision of the Tax Court, except as provided in section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, the manner provided in section 1254 of Title 28 of the United States Code.

Cir. 1977).

In this case, Stations and Land claimed bad debt deductions for three different types of disbursements that the corporations made. Although each type of disbursement requires a slightly different analysis, we agree with the tax court's conclusion that none of the disbursements was made with the intent to create an indebtedness of the payee to Stations or Land.

[3, 4] *A.* The first category of bad debt loss claimed as a deduction consists of distributions Stations made with Klink in March 1976 in connection with Klink's sale of his share of Stations. The existence of a debt presupposes the existence of a loan. *Alterman Foods, Inc. v. United States,* 505 F.2d 873, 875-77 (5th Cir.1974), sets forth the factors to be considered in determining whether a disbursement to a shareholder is properly characterized as a loan. These factors include: (1) whether the parties intended to create an unconditional obligation to repay, (2) whether the shareholder controlled the corporation, (3) whether any security was given, (4) whether there was a maturity date and a specific repayment schedule, and (5) whether the shareholder had the ability to repay.

[5] As consideration for Klink's share of Stations, Klink received his share of the proceeds of Stations' profit-sharing plan and the cash value of a life insurance policy Stations had held on him. Stations claimed and deducted both sums as bad debts. As the tax court correctly recognized, however, no statutory or other authority exists for these deductions. Neither the life insurance policy nor the profit-sharing plan has even one of the characteristics of a bona fide debt. Transferring the cash value of an in-

surance policy is a common occurrence when the ownership of a closely held corporation changes hands, and the transfer here occurred pursuant to an express provision of the contract of sale between Klink and the purchaser. The transfer certainly created no indebtedness. As for the profit sharing plan, IRC § 411(d)(3) required Stations to distribute the plan assets to the participants upon the termination of the plan (assuming the plan was "qualified" under IRC § 401). No indication exists that Stations had any claim to the assets in the profit-sharing plan, either before or after the sale of Station's stock. Therefore, no indebtedness could have resulted from the distribution of Klink's share of the plan assets.

[6] The final component of the first type of bad debt loss involves the assumption of a debt of Johnstone. When Klink was negotiating the sale of Stations, the prospective purchasers noted an alleged debt of Johnstone to Stations. Klink assumed half the debt ($4588.11) to avoid upsetting the sale. Klink's proceeds from the sale were reduced by some $7000 for payment of "personal bills." Because the prospective purchasers knew Klink to be insolvent at this time, the tax court found that the $7000 had included the assumed debt of $4588.11. The court concluded that the assumed debt had been paid, and on that basis held that the Commissioner had properly disallowed the deduction of the $4588.11 as a bad debt. Stations produced no evidence to rebut the Commissioner's determination, and thus failed to bear its burden of proof on this issue. *See Brimberry v Commissioner,* 588 F.2d 975, 977 (5th Cir.1979). We therefore affirm the tax court's ruling.

[7] *B.* The second type of bad debt loss claimed by Stations and Land involves advances these corporations

made to B & K. When Stations or Land sought new sites for filling stations or built new filling stations on these sites, the corporations hired B & K to find the sites and then to act as general contractor during construction. Both Stations and Land advanced money to B & K in connection with these activities, and both contend that the advances became deductible bad debts when B & K became insolvent. The Commissioner and the tax court rejected this contention, ruling that the advances were normal progress payments for construction work rather than loans and disallowing the bad debt deduction.

The conclusion of the Commissioner and the tax court on this issue is clearly correct. Aside from the fact that Stations and Land apparently carried the advances on their books as accounts receivable, nothing in the record indicates that the parties intended the advances to create an indebtedness of B & K to Stations or Land. B & K made no repayment of any sums advanced to it from the time of the first advances in 1966 until the sale of Stations and Land in 1976, and the coporations presented no evidence that B & K was insolvent during much of this period. Stations and Land also failed to present evidence of any agreement they may have had with B & K as to an interest rate, repayment dates, or even whether B & K was obligated to repay the advances.

Stations and Land argue that the tax court's recognition that some portion of the total amount advanced to B & K may have been for B & K projects not directly involving locating and developing properties for them combined with the parties' stipulation that the advances occurred in the course of the corporations' business, requires us to reverse the Commissioner's ruling that Stations and Land

were not entitled to deduct their advances as bad debts. Stations and Land argue that reversal is required because no statute, regulation, or case requires them to establish a precise allocation of the amount advanced for developing service stations and the amount advanced for other projects. This contention is meritless. Because Stations and Land are required to establish every element of any claimed deduction, the corporations have the burden of establishing the exact amount of any advances not used to develop service stations pursuant to a debtor-creditor relationship. *Watson v. Commissioner*, 613 F.2d 594, 599 n. 7 (5th Cir. 1980). Stations and Land have failed to meet this burden because they have failed to establish that any debt existed between them and B & K. That the advances occurred in the ordinary course of the corporations' business is irrelevant. We hold that the tax court properly upeld the Commissioner's disallowance of the corporation's deduction for the advances to B & K.

C. The final type of bad debt loss claimed as a deduction involves disbursements Stations made to Computer, a corporation formed to market computer programs that Stations had developed. Stations, Klink, and Johnstone, among others, were shareholders in Computer. For several years, substantially all of Computer's operating expenses were paid by Stations. Stations paid some of the advances to third parties for expenses incurred on Computer's behalf and some directly to Computer. Some of the advances were reflected by promissory notes payable on demand and some were simply carried by Stations as receivables. No payments of interest or principal were made on any of these notes or advances, and Stations claimed a bad debt deduction for the total amount of advances it had made to Computer.

[8, 9] The Commissioner disallowed this deduction, finding that the advances were capital contributions rather than loans, and the tax court affirmed the Commissioner's finding. We hold that the decision of the Commissioner and the tax court on this issue was correct. In *Texas Farm Bureau v. United States*, 725 F.2d 307 (5th Cir. 1984), we listed the factors to be considered in determing whether an advance is a loan or contribution to capital. These factors are: (1) the names given to the instruments evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of the payments; (4) the right to enforce payment of principal and interest; (5) the resulting participation in management; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from third-party lenders; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement. *Id.* at 311; *see also Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir.1972).

Applying the *Texas Farm Bureau* factors to the facts of this case, we conclude that the Commissioner properly characterized Stations' disbursements to Computer as capital contributions rather than loans. Computer was severly undercapitalized from its beginning. There was no fixed maturity date for repayment of any of the advances. Furthermore, Computer made no repayment of principal or interest, and because the advances were used to meet Computer's day-to-day operating expenses, Stations could have expected repayment only if Computer became a successful business enterprise. The record indicates that beginning in

1973 or 1974, Computer was unable to obtain additional financing from third parties.[2] Finally, although some of the advances were evidenced by demand notes, these notes were not issued contemporaneously with the individual advances but rather at irregular intervals to memorialize the aggregate total advanced at various times. And although the notes set an interest rate of ten percent, no interest was collected. The existence of the notes under these circumstances does little to establish capital contributions. *See Texas Farm Bureau*, 725 F.2d at 312. In view of this evidence, the tax court's characterization of Stations' advances to Computer as capital contributions was correct.

For the foregoing reasons, the judgment of the tax court is

AFFIRMED.

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[2] Stations argues that the tax court erroneously found that Computer was unable to obtain third-party financing. In particular, Stations contends that the tax court ignored Computer's "Software License Agreement" with Greyhound Computer Corporation (Greyhound), dated January 3, 1975, in which the parties acknowledged that Greyhound had extended the maturity date on Computer's $300,000 debt and had agreed to loan computer an additional $1,500,000. This provision of the agreement, Stations contends, proves that Computer could obtain third-party financing and constitutes persuasive evidence that Stations' advances to Computer were loans. We disagree.

First, the loan package between Greyhound and Computer mentioned in the Software License Agreement appears to be simply a minor component of the license agreement, under which Computer agreed to transfer substantially all its assets to Greyhound in exchange for royalty payments. (Greyhound later exercised its option to terminate this contract.) Second, even if the loan from Greyhound had been independent of other transactions, it cannot be considered persuasive evidence that Computer was able readily to obtain third-party financing at this time, for Computer's financial records indicate that it was insolvent and had been for some time. Finally, even if we accepted Stations' contention regarding the loan at face value, this evidence would be insufficient, in view of the overwhelming evidence suggesting that Stations' advances to Computer were capital contributions, to sustain Stations' burden of proof to show that the advances were loans.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 84-4042

PIGGY BANK STATIONS, INC.,
Petitioner-Appellant,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the United States Tax Court

ON SUGGESTION FOR REHEARING EN BANC
(Opinion 3/21/85, 5 Cir., 198__, ____F.2d____)
(April 25, 1985)

Before GEE, WILLIAMS and JOLLY, Circuit Judges.

PER CURIAM:

(✓) Treating the suggestion for rehearing en banc as a petition for panel rehearing, it is ordered that the petition for panel rehearing is DENIED. No member of the panel nor Judge in regular active service of this Court having requested that the Court be polled on rehearing en banc (Federal Rules of Appellate Procedure and Local Rule 35), the suggestion for Rehearing En Banc is DENIED.

( ) Treating the suggestion for rehearing en banc as a petition for panel rehearing, the petition for panel rehearing is DENIED. The judges in regular active service of this Court having been polled at the request of one of said judges and a majority of said judges not having voted in

favor of it (Federal Rules of Appellate Procedure and Local Rule 35), the suggestion for Rehearing En Banc is DENIED.

ENTERED FOR THE COURT:

United States Circuit Judge

CLERK'S NOTE:
SEE FRAP AND LOCAL RULES 41 FOR STAY OF THE MANDATE.

U.S. COURT OF APPEALS
FILED
APR 25 1985
GILBERT F. GANUCHEAU
CLERK

SEC. 166. BAD DEBTS.

(a) General Rule.—

(1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts.—When satisfied that a debt is recoverable only in part, the Secretary may allow such debts, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of Deduction.—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Reserve for Bad Debts.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary) a deduction for a reasonable addition to a reserve for bad debts.

(d) Nonbusiness Debts.—

(1) General rule.—In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

Last amendment.—Sec. 166(d)(1)(B) appears above as amended by Sec. 1001(b)(1) of Public Law 98-369, July 18, 1984, effective (Sec. 1001 (e) of P.L. 98-369) for property acquired June 22, 1984, and before Jan. 1, 1988.

Prior amendments.—Sec. 166(d)(1) was previously amended by the following:

Sec. 1402(b)(1)(A) of Public Law 94-455, Oct. 4 1976, effective (Sec. 1402(b)(1) of P.L. 94-455) with respect to taxable years beginning in 1977.*

Sec. 1402(b)(2) of Public Law 94-455, Oct. 4, 1976, effective (Sec. 1402(b)(2) of P.L. 94-455) with respect to taxable years beginning after Dec. 31, 1977.*

*Sec. 166(d)(1) as so amended is in P-H Cumulative Changes.

(2) **Nonbusiness debt defined.**—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

Last amendment.—Sec. 166(d)(2) appears above as amended by Sec. 8 of Public Law 85-866, Sept. 2, 1958 (qualified effective date rule in Sec. 1(c)(1) of P.L. 85-866(d)(2) as it read before this amendment is in P-H Cumulative Changes.

(e) Worthless Securities.—This section shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C).

(f) [Repealed]

Repealer.—Sec. 166(f) was repealed by Sec. 605(a) of Public Law 94-455, Oct. 4, 1976, effective (Sec. 605(c) of P.L. 94-455) as to guarantees made after Dec. 31, 1975, in taxable years beginning after such date. Sec. 166(f) as it read before this repealer is in P-H Cumulative Changes.

(f) Reserve for Certain Guaranteed Debt Obligations.—

(1) Allowance of deduction.— In the case of a taxpayer who is a dealer in property, in lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary) for any taxable year ending after October 21, 1965, a deduction—

(A) for a reasonable addition to a reserve for bad debts which may arise out of his liability as a guarantor, endorser, or indemnitor of debt obligations arising out of the sale by him of real property or tangible personal property (including related services) in the ordinary course of his trade or business; and

(B) for the amount of any reduction in the suspense account required by paragraph (4)(B)(i).

(2) Deduction disallowed in other cases.— Except as provided in paragraph (1), no deduction shall be allowed to a taxpayer for any addition to a reserve for bad debts which may arise out of his liability as guarantor, endorser, or indemnitor of debt obligations.

(3) **Opening balance.**—The opening balance of a reserve described in paragraph (1)(A) for the first taxable year ending after October 21, 1965, for which a taxpayer maintains such reserve shall, under regulations prescribed by the Secretary, be determined as if the taxpayer had maintained such reserve for the preceding taxable years.

(4) **Suspense account.**—

(A) Requirement.—Except as provided by subparagraph (C), each taxpayer who maintains a reserve described in paragraph (1)(A) shall, for purposes of this subsection and section 81, establish and maintain a suspense account. The initial balance of such account shall be equal to the opening balance described in paragraph (3).

(B) Adjustments.—At the close of each taxable year the suspense account shall be—

(i) reduced by the excess of the suspense account at the beginning of the year over the reserve described in paragraph (1)(A) (after making the addition for such year provided in such paragraph), or

(ii) increased (but not to an amount greater than the initial balance of the suspense account) by the excess of the reserve described in paragraph (1)(A) (after making the addition for such year provided in such paragraph) over the suspense account at the beginning of such year.

(C) Limitations.—Subparagraphs (A) and (B) shall not apply in the case of the taxpayer who maintained for his last taxable year ending before October 22, 1965, a reserve for bad debts under subsection (c) which included debt obligations described in paragraph (1)(A).

(D) Section 381 acquisitions.—The application of this paragraph in any acquisition to which section 381(a) applies shall be determined under regulations prescribed by the Secretary.

Last amendment.—Sec. 166(f) (formerly Sec. 166(g)) appears above as redesignated by Sec. 605(a) of Public Law 94-455, Oct. 4, 1976, effective (Sec. 605(c) of P.L. 94-455) as to guarantees made after Dec. 31, 1975, in taxable years beginning after such date. Sec. 166(f) (formerly Sec. 166(g)) as it read before this amendment is in P-H Cumulative Changes.

Addition.—Sec. 166(f) (formerly Sec. 166(g)) was added by Sec. [1](a) of Public Law 89-722, Nov. 2, 1966 (qualified effective date rule in Sec. 2 of P.L. 89-722).

(g) Cross Reference.—

(1) For disallowance of deduction for worthlessness of debts owed by political parties and similar organizations, see section 271.

(2) For special rule for banks with respect to worthless securities, see section 582.

(3) For special rule for bad debt reserves of certain mutual savings banks, domestic building and loan associations, and cooperative banks, see section 593.

(4) For special rule for bad debt reserves of banks, small business investment companies, etc., see sections 585 and 586.